International Capital Flows

Christopher D. Piros & Jerald E. Pinto, *Economics For Investment Decision Makers: Micro, Macro and International Economic*, 2013, Chapter 8

Balance Of Payments (BOP)

- The BOP is a measurement system used to summarize a **country's economic transactions with the rest of the world** for a particular period of time (quarter or year).

- The BOP reflects payments for exports and imports, financial transactions and financial transfers

- Every transaction involves both a debit and a credit. Thus, **the net balance of all entries on the BOP should equal zero** (this is rarely the case in practice because of the use of different sources).

BOP Components

- The BOP is composed of:
  - The current account (measures the flow of G & S)
  - The capital account (measures transfers of capital)
  - The financial account (records investment flows)

Current Account	Capital Account	Financial Account
• Trade balance (merchandise, services) • Income balance • Net unilateral transfers	• Capital transfers • Sales and purchases of non-produced, non-financial assets	• Financial assets abroad • Foreign-owned financial assets

National Economic Accounts and the BOP

- The BOP is affected by the decisions of consumers, firms and governments.

- The national economic identity for an open economy is:

$$Y = C + I + G + X - M$$

Where Y: GDP, C: private consumption, I: investment, G: government purchases of goods and services, X: exports and I: imports.

- Net exports (X – M) is the **equivalent of** the current account balance from a BOP perspective.

- Trade balance is usually the dominant component of the current account

- If X > M (X < M), the current account is in surplus (deficit).

National Economic Accounts and the BOP

- A current account surplus or deficit can affect GDP (and employment)

$$CA = X - M = Y - (C + I + G)$$

Where CA denotes current account balance.

- In order for the BOP to balance, a deficit or surplus in the current account must be offset by an opposite balance in the sum of the capital and financial accounts.

- A country can have a **current account deficit** and consume more output than it produces only by borrowing money from foreigners.
- A country with a **current account surplus** (e.g China) finances the current account deficit of its trading partners by lending to them (granting bank loans, investing in financial and real assets)

National Economic Accounts and the BOP

- Decisions by consumers, firms and governments influence the BOP.

- Let's define the disposable income Y^d as follows:

$$Y^d = Y + R - T$$

Where T denotes taxes and R net transfers that the private sector receives in addition to national income

- As disposable income is allocated to consumption and saving, we have:

$$Y^d = C + S_p$$

Where S_p denotes private sector saving

We will have $C = Y^d - S_p = Y + R - T - S_p$

Substituting for C in the current account balance equation, we will obtain:

$$CA = S_p - I + (T - G - R)$$

National Economic Accounts and the BOP

We have:

$$CA = S_p - I + (T - G - R)$$

T – G – R is the government spending or government savings S_g

We will have:

$$S_p + S_g = I + CA$$

- An **open** economy can use its saving for domestic investment or for foreign investment (e.g buying foreign assets). A **closed** economy savings can be used only for domestic investment

- An open economy is not constrained by its domestic savings rate to exploit promising investment opportunities:
  - It can increase investment by increasing foreign borrowing (↓ in CA) without increasing domestic savings

National Economic Accounts and the BOP

$$CA = S_p + S_g - I$$

A current account deficit results from:

- Low private savings
- High private investment
- Government deficit
- A combination of the three

National Economic Accounts and the BOP

$$CA = X - M = Y - (C + I + G)$$

- A current account deficit tends to reflect a strong domestic economy (high consumer, investment and government spending)

- This usually goes with high domestic credit demand and high interest rates

- In the long run, a persistent current account deficit leads to a permanent increase in the claims held by other countries against the deficit country

- Consequently, foreign investors may require rising risk premiums for such claims (this will lead to a depreciating currency)

Balance of Payments (BOP)

- **Debits**: Increase in Assets, Decrease in Liabilities
- **Credits**: Decrease in Assets, Increase in Liabilities

Debits	Credits
• Value of imported goods and services • Purchases of foreign financial assets • Receipt of payments from foreigners • Increase in debt owed by foreigners • Payment of debt owed to foreigners	• Payments for imports of goods and services • Payments for foreign financial assets • Value of exported goods and services • Payment of debt by foreigners • Increase in debt owed to foreigners